SOAH DOCKET NO. 473-21-0538

PUC DOCKET NO. 51415

PUBLIC UTILITY COMMISSION OF TEXAS

APPLICATION OF

SOUTHWESTERN ELECTRIC POWER COMPANY

FOR AUTHORITY TO CHANGE RATES

REBUTTAL TESTIMONY OF

DAVID A. HODGSON

FOR

SOUTHWESTERN ELECTRIC POWER COMPANY

APRIL 23, 2021

TESTIMONY INDEX

EXHIBITS

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS.

A. My name is David A. Hodgson and I am the Manager of Tax Accounting and Regulatory Support for American Electric Power Service Corporation (AEPSC), a subsidiary of American Electric Power Company, Inc. (AEP). My business address is American Electric Power, 1 Riverside Plaza, Columbus, Ohio 43215.

Q. DID YOU FILE DIRECT TESTIMONY IN THIS CASE ON BEHALF OF SOUTHWESTERN ELECTRIC POWER COMPANY (SWEPCO OR THE COMPANY)?

A. Yes.

II. PURPOSE OF REBUTTAL TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to address certain positions taken by Ms. Ruth Stark on behalf of the Rate Regulation Division of the Public Utility Commission of Texas (PUCT or Commission) also referred to as "Staff." I address Staff's recommendations regarding SWEPCO's separate return net operating loss (NOL) carryforward. I also address Staff's recommendations on the Company's balance and amortization of protected and unprotected excess accumulated deferred federal income taxes (ADFIT).

III. NET OPERATING LOSS CARRYFORWARD

Q. ON PAGE 30 OF HER DIRECT TESTIMONY, MS. STARK STATES THAT THE COMPANY "FICTITIOUSLY ASSUMES THE FILING OF A SEPARATE" RETURN. CAN YOU PLEASE DISCUSS THIS TOPIC?

A. Yes. The Company is a member of a consolidated group with its parent, AEP. Accordingly, the Company participates in the filing of a consolidated federal income tax return as Staff points out. However, the use of the separate return method is widely accepted and even required as the method to calculate federal income taxes for ratemaking purposes. The discussion of the separate return method will also often be referred to as the stand-alone method within ratemaking documents. It ensures that customer rates will include no more and no less than the taxes attributable to the revenues and expenses that are included in those rates. The separate return method matches the tax expense component of cost of service and the ADFIT component of rate base with the corresponding revenues, expenses, and assets also reflected in the utility's cost of service and rate base.

Q. HAS THE STATE OF TEXAS ADDRESSED THE SEPARATE RETURN APPROACH?

A. Yes. The Texas Legislature, in amending the Public Utility Regulatory Act (PURA), determined that the taxes included in rates should be determined on a separate return basis. On the topic of consolidated income tax returns, PURA §36.060(a) states:

> If an expense is allowed to be included in utility rates or an investment is included in the utility rate base, the related income tax benefit must be included in the computation of income tax expense to reduce the rates. If an expense is not allowed to be included in utility rates or an investment is not included in the

utility rate base, the related income tax benefit may not be included in the computation of income tax expense to reduce the rates.

The language of this section precludes the inclusion of any tax attributes included in rates that are attributable to any company that is not the rate setting utility – in other words, the statute requires the Company to use the separate return method. During the 83rd legislative session (2013), the Texas Legislature enacted Senate Bill 1364, attached as Exhibit DAH-4R, which repealed the prior version of PURA §36.060(a) and replaced it with the above-quoted version now in effect.[1] The prior version required a consolidated tax adjustment, which would adjust SWEPCO's tax expense by the impact of its NOL carryforward on the consolidated tax group. However, the requirement of a consolidated tax adjustment was specifically repealed in 2013.[2] Staff's recommendation to disallow SWEPCO's NOL carryforward in this case is the exact type of consolidated tax adjustment the Texas Legislature repealed in 2013.

Moreover, since investments in rate base and expenses in cost of service are only included in rates if they are for the purpose of providing utility service, it follows that the ADFIT in rate base and the tax expense in cost of service likewise should be limited to only those taxes that are associated with providing utility service to customers. A tax benefit or detriment resulting from the Company's participation in a consolidated tax return would not be directly associated with providing utility service, and therefore, that benefit or detriment should not be included in rates.

[1] Act of May 25, 2013, 83rd Leg., R.S., chapter 787 (SB 1364), §1.
[2] See Exhibit DAH-4R also includes additional legislative analysis relating to SB 1364 and affirms Texas Legislature's repeal of the consolidated tax adjustment.

The Commission has also weighed in on this topic in its decision in the Lone Star proceeding (Docket No. 40020).[3] Staff's recommendation is inconsistent with the Commission precedent established in Docket No. 40020. In that case, the Commission determined that it was appropriate to calculate Lone Star's federal income tax expense on a standalone basis.[4] The Commission further held that it was not appropriate to look to the tax attributes of Lone Star's corporate parent in setting utility rates. In discussing Lone Star's NOL deferred tax asset, the Administrative Law Judges made the following assertion:

> On a stand-alone basis, Lone Star's ADFIT liability related to bonus depreciation will be reflected in the Company's rate base when the NOL has been realized and the tax benefit of bonus depreciation realized.[5]

The Company's position in this proceeding is consistent with Lone Star in Docket No. 40020. The Company is requesting rates to be set using the separate return method.

Q. BOTH YOU AND STAFF ADDRESS NORMALIZATION REQUIREMENTS IN YOUR DIRECT TESTIMONY. CAN YOU PLEASE PROVIDE A SUMMARY OF THOSE REQUIREMENTS?

A. Yes. With respect to accelerated depreciation, the normalization rules require that the federal tax expense included in the cost of service for ratemaking use a method of depreciation and a depreciation period that is no shorter than the depreciation expense used in setting rates.[6] With respect to NOL carryforwards, the normalization rules require that the NOL carryforward ADFIT be included in rate base to the extent that

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[3] Application of Lone Star Transmission, LLC for Authority to Establish Interim and Final Rates and Tariffs, Docket No. 40020, Order on Rehearing (February 12, 2013), Finding of Fact No. 125, page 19.
[4] *Id.* at Finding of Fact Nos. 125, 126, and 129, page 19.
[5] Application of Lone Star Transmission, LLC for Authority to Establish Interim and Final Rates and Tariffs, Docket No. 40020, Proposal for Decision (September 6, 2012), page 56.
[6] 26 U.S. Code §168(i)(9)(A)(i)

the NOL carryforward is the result of accelerated depreciation.[7] Another important aspect of the normalization rules is the consistency requirement. The normalization rules require there to be consistency with the assumptions used in the revenue requirement for depreciation expense, tax expense, rate base, and the reserve for deferred taxes (or ADFIT).[8]

Q. DO STAFF'S RECOMMENDATIONS CAUSE CONCERN WITH RESPECT TO THE NORMALIZATION RULES?

A. Yes. Despite the Company's NOL carryforward being the result of accelerated depreciation, Staff suggests that the normalization rules do not apply and that the NOL carryforward ADFIT should be excluded from rate base. Staff's recommendation to break the connection between the tax expenses in the cost of service and the ADFIT in rate base do not adhere to the consistency requirement of the normalization rules. Company Witness Brad Seltzer addresses Staff's arguments on these normalization rules in greater detail in his rebuttal testimony.

Q. STAFF SUGGESTS THAT THE COMPANY DOES NOT SEEM TO HAVE A REAL CONCERN WITH NORMALIZATION AS IT HAS NOT REPORTED ITSELF TO THE IRS. CAN YOU DISCUSS?

A. Yes. The IRS has issued guidance on the topic of correcting normalization inconsistencies.[9] First, in order to be considered a violation, a company or regulatory commission must knowingly put into rates a practice or procedure that is inconsistent with the normalization rules. It is not suggested nor stated that either SWEPCO or the

[7] Treas. Reg. § 1.167(l)-1(h)(1)(iii) and Private Letter Rulings issued by the IRS.
[8] 26 U.S.C. § 168(i)(9)(B).
[9] Internal Revenue Service, Revenue Procedure 2017-47.

Commission were aware of the inconsistency with the normalization rules that came about from excluding the NOL carryforward when rates were put into place as a result of Docket No. 46449.

Second, the IRS allows for taxpayers to change to a practice or procedure that is consistent with the normalization rules with its next available opportunity before it will assert that a normalization violation has occurred. As stated later in my rebuttal, the Company identified the normalization inconsistency in the preparation for this case. As a result of the risk identification, the Company is now using its next available opportunity by seeking a correction of the inconsistency with the request for rates in this base case.

Q. STAFF STATES THAT PURA §36.060(a) ONLY DIRECTS HOW FEDERAL INCOME TAX EXPENSES ARE TO BE DETERMINED AND DOES NOT ADDRESS HOW ITEMS ARE TO BE REFLECTED IN RATE BASE. DO YOU AGREE WITH THIS OPINION?

A. No, I do not agree. Again, Staff's reasoning is inconsistent with the Lone Star case in Docket No. 40020. Furthermore, the ADFIT balance that is included as a reduction to rate base is inherently tied to tax expense. The ADFIT balance represents the sum of the deferred tax expense that the Company will owe in the future. The customers have already paid this deferred or future tax expense amount and it has been recorded on the Company's books. As the Company pays its taxes year over year, the difference between what it has collected from customers and what it pays to the Internal Revenue Service (IRS) shrinks. That is, as the Company's tax bill goes up, its ADFIT balance goes down. Staff ignores this connection. Staff recommends calculating the tax expense in one fashion and the

Company's ADFIT balance and rate base in another fashion. This recommendation is incompatible with the principles of deferred tax accounting in ratemaking. Additionally, PURA §36.060(a) explicitly states that if an investment is not included in the utility rate base, then the related income tax benefit may not be included in the computation of income tax expense to reduce rates. The assets of other AEP affiliates are not included in the Company's rate base. Therefore, the tax benefits of those AEP affiliates should not be included in SWEPCO's ADFIT component of rate base. Moreover, Staff's recommendations are inconsistent with the IRS's normalization requirements.

Q. CAN YOU FURTHER EXPLAIN THIS CONNECTION WITH DEFERRED TAX EXPENSE AND ADFIT?

A. Yes. Normalized accounting for income taxes calculates income tax on the income and expense included in the cost of service for ratemaking purposes. This income tax expense is adjusted for permanent differences between the income and expense for ratemaking purposes and for tax purposes. The resulting tax expense is then divided between current tax expense and deferred tax expense. Current tax expense is equal to the amount of taxes currently payable to the IRS. It is recorded to the balance sheet as a current liability. Deferred tax expense is calculated based on temporary timing differences between book and tax income, and is the difference between the total tax expense and the current taxes payable to the IRS. Deferred tax expense is recorded on the balance sheet as an ADFIT liability or asset. The ADFIT balance is used to offset rate base. To the extent the Company's future or deferred taxes are greater than its currently payable tax expense, the ADFIT balance reduces rate base.

Q. CAN YOU EXPLAIN THE RATIONALE OF PROVIDING A RATE BASE REDUCTION FOR ADFIT?

A. Yes. Included in the revenue requirement is the total tax expense of a utility – both currently payable and deferred or future owing taxes. As I described above, only the current tax expense must be paid to the IRS. The utility has the benefit of collecting deferred tax expense in its rates, but does not have an obligation to make a payment to the IRS until a future period. You will often hear this referred to as an interest free loan from the government or as government supplied cost free capital. The tax code allows the utility to accelerate certain deductions creating the temporary difference between the currently payable tax expense and the future tax expense (i.e., the interest free loan). However, the actual funding of this loan comes from customers through the funds collected by the utility as a result of the inclusion of deferred tax expenses in the revenue requirement. Because customers have provided funds in excess of the amount the utility is required to remit to the IRS, it is only fair and equitable to reduce rate base by this temporary difference – the ADFIT balance.

Q. CAN YOU PLEASE PROVIDE AN EXAMPLE OF HOW THIS WORKS?

A. Yes. Let me first show the calculation of the total income tax expense. For this simple example we will assume no permanent differences between book and tax income. If the utility has $10,000 in pre-tax book income (revenue requirement) and the statutory tax rate is 21%, the result would be a total tax expense of $2,100 to be included in rates.

Total Income Tax Expense Calculation	
Pre-Tax Net Income	10,000
Statutory Tax Rate	21%
Total Tax Expense	2,100

Now let's say that the utility was able to accelerate its depreciation deductions for tax purposes resulting in a taxable income that is lower than book income.

	Taxable Income
Pre-Tax Book Income	10,000
Accelerated Tax Deduction	(4,000)
Taxable Income (Loss)	6,000
	21%
Current Tax Expense	1,260

As a result of the accelerated tax deductions, the utility's current tax expense is $1,260 ($6,000 x 21%). The $840 difference between the total tax expense of $2,100 and the current tax expense of $1,260 is the tax liability that the utility was able to defer. The $840 that customers have provided in rates is then taken as a reduction to rate base in the form of a deferred tax liability.

	Taxable Income		Tax Rate	(DTL) / DTA
Pre-Tax Book Income	10,000			
Accelerated Tax Deduction	(4,000)	x	21%	(840)
				(840)
Taxable Income (Loss)	6,000			
	21%			
Current Tax Expense	1,260			

Q. CAN YOU PLEASE PROVIDE AN EXAMPLE OF THIS WITH A NET OPERATING LOSS?

A. Yes. For this example, we will use the same pre-tax book income of $10,000. This will again result in total tax expense of $2,100. Now let's say that instead of the accelerated tax depreciation deduction of $4,000 in the last example, the utility is able to deduct $11,000.

	Taxable Income
Pre-Tax Book Income	10,000
Accelerated Tax Deduction	(11,000)
Taxable Income (Loss)	(1,000)
Net Tax Loss Carry Forward	1,000
Taxable Income After Net Operating Loss	0
	21%
Current Tax Expense	0

Because the accelerated tax deductions exceeds the pre-tax book income, the utility has a NOL of $1,000 and therefore no current tax payable to the IRS. The $2,100 difference between the total tax expense of $2,100 and the current tax expense of $0 is the tax liability the utility was able to defer. As customers have provided $2,100 for tax expense in rates that the utility does not currently owe to the IRS, it is fair and equitable to reduce rate base by the $2,100 ADFIT.

	Taxable Income		Tax Rate	(DTL) / DTA
Pre-Tax Book Income	10,000			
Accelerated Tax Deduction	(11,000)	x	21%	(2,310)
				(2,310)
Taxable Income (Loss)	(1,000)			
Net Tax Loss Carry Forward	1,000	x	21%	210
Taxable Income After Net Operating Loss	0			(2,100)
	21%			
Current Tax Expense	0			

As you can see, the $2,100 ADFIT includes both a deferred tax liability of $2,310 (11,000 x 21%) related to the accelerated tax deduction as well as a deferred tax asset of $210 (1,000 x 21%) related to the NOL carryforward. In both examples, the ADFIT rate base reduction is directly tied to the deferred tax expense included in rates. In order to maintain consistency between deferred tax expense and rate base, it is necessary to include both the deferred tax liability of $2,310 and the deferred tax asset of $210 in the total ADFIT used to calculate rate base.

Q. HOW DOES THE RECOMMENDATION OF STAFF DIFFER FROM THE EXAMPLE YOU PROVIDED?

A. The testimony provided by Staff recommends that the deferred tax asset associated with the separate return NOL should be excluded from the total ADFIT balance. In the context of the second example, Staff's recommendation would be to reduce rate base by the $2,310 deferred tax liability regardless of the fact that customers had only provided an interest free loan to the utility in the amount of the $2,100 deferred tax expense. Staff's recommendation results in the tax benefits of AEP affiliates that are received by the Company under the tax allocation agreement to produce the result of the full deferred tax liability resulting from accelerated depreciation to reduce rate base. The PLRs that are referenced in my direct testimony all provide that such a result would violate the normalization rules.

Q. WHY DOES STAFF SUGGEST THAT IT IS APPROPRIATE TO REDUCE RATE BASE BY AN AMOUNT THAT EXCEEDS THE TAX EXPENSE FOR WHICH CUSTOMERS HAVE PAID?

A. Staff indicates that because the Company has received cash payments for its NOL through a tax allocation agreement with its consolidated tax return group, it is not fair to include the NOL carryforward in ADFIT. Staff goes on to point out that the consolidated return "group as a whole still has the same amount of cash on a consolidated basis. It merely took the money out of one pocket and put it in another."

Q. DO YOU AGREE WITH STAFF'S ARGUMENT FOR REJECTING THE NOL?

A. No, I do not. First, Staff's recommendation ignores the longstanding ratemaking principle that deferred tax expense and ADFIT are inextricably linked. As discussed above, rate base is reduced by ADFIT because it represents the cumulative amount of deferred tax expense that customers have paid to the Company in excess of income tax the Company is currently obligated to pay to the federal government. As shown in the example, in order to achieve a balance between the rate base reduction and the amount of cash provided through rates for deferred tax expense, it is necessary to include the NOL deferred tax asset in the overall ADFIT balance. To exclude the NOL deferred tax asset would result in rate base being reduced by an amount greater than the deferred taxes the Company received through rates. Including the NOL carryforward in the ADFIT balance provides an accurate representation of the overall rate base reduction and is commensurate with regulated operations and assets of the utility.

Second, the argument for rejecting the NOL results in the cross-subsidization of costs/benefits from affiliate companies. Staff describes the cash payments that resulted from the tax allocation agreement by saying that AEP "took money out of one pocket and put in in another."[10] The suggestion is that taking the money out of an affiliate's pocket and putting it into the pocket of SWEPCO should result in a reduction in SWEPCO's utility rates. Instead of the rate base reduction being based on the deferred tax expense that customers have funded, Staff suggests that part of that rate base reduction should be funded by the customers of affiliate companies.

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[10] Stark Direct 40:20

The idea that the tax allocation agreement simply takes "money out of one pocket and put it in another" also creates operational risk for both SWEPCO and its affiliates.[11] Again, Staff recommends that the NOL deferred tax asset should not be included in rate base because the Company received a payment under the tax allocation agreement. This would result in a reduction to the Company's requested rates. However, Staff's approach ignores the economic realities of the tax allocation agreement. Let's assume that an affiliate company (Utility B) had a current tax liability. Utility B would have made a cash payment for its current tax liability to AEP. With SWEPCO having a taxable loss, it would have received a cash payment from AEP (to the extent that taxable loss was used by the group) under the tax allocation agreement. The regulator of Utility B could make the same argument as Staff that because this transaction simply "took money out of one pocket and put it in another" that Utility B's current tax expense was actually deferred. Utility B's regulator could then argue that this tax was deferred and that the additional deferral should also be a reduction to Utility B's rate base. Staff's recommendation, when taken to its logical extension, builds problem on top of problem. Both SWEPCO and Utility B could face rate base reductions over the same cash transfer under the tax allocation agreement. Instead, the prudent and legally required approach is the separate return approach. This aligns the tax benefits and burdens of each regulated utility with the tax expense and rate base for that utility with no consideration for any affiliate or upstream, downstream, or side-stream activity.

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[11] SWEPCO's Response to Staff's 9th RFI at Staff 9-21.

Q. PART OF STAFF'S ARGUMENT IN REJECTING THE NOL IS WHAT IS DESCRIBED AS THE ECONOMIC REALITY OF IT. IS THERE A FLAW IN THIS ARGUMENT?

A. Yes there is. The flaw in Staff's argument is that it fails to capture the overall rate impact of the NOL carryforward ADFIT and the funds received as a result of the Company's tax allocation agreement. Staff testimony focuses solely on the rate impact of the NOL carryforward ADFIT and ignores the rate impact of the funds received by the Company through the tax allocation agreement. These two items cannot be looked at in isolation or it skews the economic reality of the situation. When you look at the overall impact of the Company's request you see that the end result is neutral on rates with respect to the NOL carryforward ADFIT and the cash receipts as a result of the tax allocation agreement. The end result provides consistency with the requirements of PURA §36.060. That is, within rates, there should be no tax benefits and no tax detriments but those that are the direct result of providing utility service to customers.

What is missing in the analysis provided by Staff is that the Company's rates as approved in Docket No. 46449, and others prior to it, reflect a reduction as a result of the cash received through the tax allocation agreement. Staff has pointed out in its testimony, and the Company has acknowledged, that the Company has received cash as a result of its tax allocation agreement. Being a rate regulated utility, the Company must prudently invest its capital into plant that is to the benefit of providing service to its customers. The Commission reviews the prudency of those investments when approving the Company's rates. To the extent that the Company received cash through its tax allocation agreement, the Company would not use that additional capital to build plant beyond what would be prudent in serving its customers. Instead, the cash received by the Company through the tax allocation agreement would reduce the otherwise needed capital to fund those prudent investments. As a result, the Company would need less capital through debt and equity than it would have absent the cash received through the tax allocation agreement.

Q. CAN YOU DEMONSTATE HOW THE COMPANY'S REQUEST RESULTS IN A NEUTRAL IMPACT ON RATES WITH RESPECT TO THE NOL CARRYFORWARD AND THE CASH RECEIPTS THROUGH THE TAX ALLOCATION AGREEMENT?

A. Yes. I will provide two examples. The first example will involve a company with no tax allocation agreement. The second example will involve a company with a tax allocation agreement. I will then apply both Staff's and the Company's recommended approach to the second example. The results will show that the Company's approach produces the same revenue requirement as the first example involving a company with no tax allocation agreement. Staff's approach does not match the first example.

Example 1

Let's start with the same example from earlier in my testimony where a utility has pre-tax book income of $10,000 and a deduction for accelerated tax depreciation of $11,000. As in the example before, this results in an NOL of $1,000, a deferred tax liability of $2,310, and a deferred tax asset of $210.

	Taxable Income		Tax Rate	(DTL) / DTA
Pre-Tax Book Income	10,000			
Accelerated Tax Deduction	(11,000)	x	21%	(2,310)
				(2,310)
Taxable Income (Loss)	(1,000)			
Net Tax Loss Carry Forward	1,000	x	21%	210
Taxable Income After Net Operating Loss	0			(2,100)
	21%			
Current Tax Expense	0			

Now, let's look at a basic capital structure where a utility has debt and equity both of $100,000. We will use a rate of 4% for the debt component and 10% for the equity component. This will result in a weighted cost of capital of 2% and 5% respectively for the debt and equity for a total weighted average cost of capital (WACC) of 7%

	Initial Capital	Defd Tax Customer	Adjusted Capital	Ratio	Cost	Weighted Cost
Debt	100,000	(1,050)	98,950	50.00%	4.00%	2.00%
Equity	100,000	(1,050)	98,950	50.00%	10.00%	5.00%
Total	200,000	(2,100)	197,900			7.00%

As you can see, the required debt and equity to fund the plant are reduced by the deferred taxes the utility collected from customers through rates. The net rate base is composed of plant of $200,000 and a net ADFIT liability of $2,100.

Plant	200,000
DTL	(2,310)
DTA	210
Net Rate Base	197,900
	7%
Rev Req	13,853

As you can see, the ADFIT liability reduces rate base from the $200,000 in the initial capital structure to $197,900. When the rate base net of ADFIT is multiplied by the WACC of 7%, the result is a revenue requirement of $13,853.

Example 2

Now, let's look at the same capital structure but assume that the utility has received $210 cash for its NOL as a result of its tax allocation agreement. We will assume that the utility uses that cash in such a manner that it maintains the same capital ratios.

	Initial Capital	Defd Tax Customer	Cash Tax Alloc	Adjusted Capital	Ratio	Cost	Weighted Cost
Debt	100,000	(1,050)	(105)	98,845	50.00%	4.00%	2.00%
Equity	100,000	(1,050)	(105)	98,845	50.00%	10.00%	5.00%
Total	200,000	(2,100)	(210)	197,690			7.00%

As you can see, the total need for capital raised from debt and equity is reduced by the $210 resulting in a new total of $197,690. We will assume that the rates for debt and equity remain the same which results again in a WACC of 7%.

For this second example, we will incorporate Staff's recommendation for the rate base treatment of the NOL carryforward. That is to say, the deferred tax asset related to the NOL will be reduced by the payment received as a result of the tax allocation agreement. So for this example, the net rate base of the utility will be $197,690.

Plant	200,000
DTL	(2,310)
DTA	0
Net Rate Base	197,690
	7%
Rev Req	13,838

When the rate base net of ADFIT is multiplied by the WACC of 7%, the result is a revenue requirement of $13,838. As you can see the revenue requirement has been reduced as a result of the consolidated tax adjustment. This is the exact type of result that the amendments to PURA §36.060 were intended to prevent.

Now, instead of incorporating Staff's recommendation for the rate base treatment of the NOL carryforward, let's incorporate the Company's proposed approach. In this Company example, we will include an adjustment to remove the impact to the debt and equity requirements that resulted from the funds received through the tax allocation agreement as those funds represent a consolidated tax adjustment.

	Initial Capital	Defd Tax Customer	Cash Tax Alloc	Proforma Tax Alloc	Adjusted Capital	Ratio	Cost	Weighted Cost
Debt	100,000	(1,050)	(105)	105	98,950	50.00%	4.00%	2.00%
Equity	100,000	(1,050)	(105)	105	98,950	50.00%	10.00%	5.00%
Total	200,000	(2,100)	(210)	210	197,900			7.00%

In rate base, we will include ADFIT in the amount of $2,100 which is equal to the deferred taxes the utility has collected from customers. When the rate base net of ADFIT is multiplied by the WACC of 7%, the result is a revenue requirement of $13,853 (the same as Example 1 involving no tax allocation agreement).

Plant	200,000
DTL	(2,310)
DTA	210
Net Rate Base	197,900
	7%
Rev Req	13,853

The example using the Company's approach results in the exact same revenue requirement as the first example in which the utility did not have a tax allocation agreement, both of which differ from Staff's proposal. This is important because it demonstrates that the Company's request simply seeks to remove any consolidated tax adjustments from the rates that are charged to customers. Therefore, the Company's proposed inclusion of the NOLC ADFIT in rate base simply offsets a portion of the deferred tax liability from accelerated depreciation to capture only the amounts funded by customers. The Company's request is consistent with both PURA §36.060 and the consistency requirement of the normalization rules.

Q. STAFF POINTS OUT IN TESTIMONY THAT THE COMPANY DID NOT PROPOSE THE INCLUSION OF A SEPARATE RETURN NOL CARRYFORWARD IN ITS PREVIOUS BASE CASE. CAN YOU PLEASE DISCUSS?

A. Yes. While Staff correctly states that the Company did not request the inclusion of a separate return NOL carryforward in Docket No. 46449, it does not make it any less appropriate to request its inclusion in this case.

During the preparation for this filing, the Company identified risks both from a normalization standpoint and from an operational standpoint that lead to the request for the inclusion of the NOL carryforward deferred tax asset. Company Witness Brad Seltzer's rebuttal testimony speaks to the normalization risk the Company faces. The discussion in the last Q&A speaks to the Company's operational risk. The fact that these risks were not identified until the preparation of this filing does not diminish the merits of the position.

Staff proceeds to discuss the amount of separate return NOL carryforward that the Company would have had at the end of the test year in Docket No. 46449. Staff further proposes that "if the Commission accepts SWEPCO's proposal with respect to NOLC ADFIT, it should only consider doing so with respect to tax losses that occurred after the end of the test-year in Docket No. 46449."[12] The argument is that the

[12] Stark Direct Testimony 35:5-7

Company is attempting to change the ratemaking treatment of the separate return NOL carryforward. As Staff points out, the Company did not include the NOL carryforward in its prior base case. Therefore, the Commission never ruled on the proper treatment of SWEPCO's NOL carryforward for ratemaking purposes. By this logic, an error or omission of any type in one filing could not be corrected and properly presented in a subsequent filing regardless of whether the issue had been litigated or not. The Company's request for the inclusion of the NOL carryforward ADFIT in this case simply acknowledges the fact that its currently approved rates include a tax benefit that is inconsistent with PURA §36.060 and the normalization rules and seeks to make a correction for the inconsistency.

IV. EXCESS ADFIT

Q. CAN YOU SUMMARIZE THE CONCEPT OF EXCESS ADFIT WHICH IS DISCUSSED IN YOUR DIRECT TESTIMONY AND THE TESTIMONY OF STAFF?

A. Yes. As discussed earlier in my rebuttal, utility rates are set with the total tax expense of the Company included as a component of the cost of service. The total tax expense is based on the statutory tax rate. As discussed earlier, the deferred tax portion of the total tax expense that is collected through rates is recorded on the balance sheet as an ADFIT liability (or asset). If the statutory tax rate changes, the ADFIT is revalued to reflect the liability at the new tax rate. The difference between the ADFIT balance that was built up through the collection of deferred tax expense in rates at the old statutory rate and the revalued ADFIT at the new statutory rate is excess ADFIT. Excess ADFIT therefore represents the cash that customers have paid to the utility through rates that the utility will no longer pay to the IRS in the future as a result of the change in tax rate. Said another way, it is the amount that customers have paid in "excess" of the utility's future tax liability. Where the utility has collected such taxes from customers in rates and is no longer required to pay the IRS because of the lower tax rate, it is reasonable for such "excess" to be refunded and returned to customers.

Q. STAFF REJECTS THE COMPANY'S INCLUSION OF EXCESS ADFIT RELATED TO THE SEPARATE RETURN NOL. DO YOU AGREE WITH THIS POSITION?

A. No, I do not. Staff states that excess ADFIT is the balance "that should be returned to SWEPCO's customers."[13] The key word there is "returned." The inclusion of the excess ADFIT associated with the NOL carryforward ensures that the Company returns only the amount of cash that it collected from customers through rates for its deferred taxes. Staff's recommendation would result in the Company not only returning the cash it received from customers, but providing an amount beyond what customers ever paid. The premise behind excess ADFIT is that there is a dollar-for-dollar return of cash that was over collected as a result of a rate change.

Q. CAN YOU PLEASE PROVIDE AN EXAMPLE TO DEMONSTRATE THIS POINT?

A. Yes. Let me first show the calculation of the total income tax expense. Similar to the previous examples we will assume no permanent differences between book and tax income. If the utility has $10,000 in pre-tax book income (revenue requirement), and

[13] Stark Direct at 42:3-5

the statutory tax rate is 35%, the result would be a total tax expense of $3,500 included in rates.

Total Income Tax Expense Calculation

Pre-Tax Net Income	10,000
Statutory Tax Rate	35%
Total Tax Expense	3,500

Now let's say that the utility was able to accelerate deductions for tax purposes and those deductions exceed the book income for the year thereby creating a NOL.

	Taxable Income		Tax Rate	(DTL) / DTA
Pre-Tax Book Income	10,000			
Accelerated Tax Deduction Reducing Income to Zero	(10,000)	x	35%	(3,500)
Remaining Accelerated Tax Depreciation	(1,000)	x	35%	(350)
Taxable Income (Loss)	(1,000)			(3,850)
Net Tax Loss Carry Forward	1,000	x	35%	350
Taxable Income After Net Operating Loss	0			
	35%			
Current Tax Expense	0			(3,500)

In this example, the current tax expense is zero because no tax is currently payable to the IRS as a result of the NOL. The $3,500 difference between the total tax expense and the current tax expense is the deferred tax expense. That is also the amount of taxes collected from customers in rates, deferred as the result of accelerated depreciation and the ADFIT that reduces rate base.

Next, let's assume that the tax rate changes from 35% to 21% and as a result the utility must revalue its ADFIT balance.

	Taxable Income		Tax Rate	(DTL) / DTA		Reduction to Tax Rate	Reg. (Liability)
Pre-Tax Book Income	10,000						
Accelerated Tax Deduction Reducing Income to Zero	(10,000)	x	35%	(3,500)	x	14%	(1,400)
Remaining Accelerated Tax Depreciation	(1,000)	x	35%	(350)	x	14%	(140)
Taxable Income (Loss)	(1,000)			(3,850)			(1,540)
Net Tax Loss Carry Forward	1,000	x	35%	350	x	14%	140
Taxable Income After Net Operating Loss	0						
	35%						
Current Tax Expense	0			(3,500)			(1,400)

As you can see, a regulatory liability (asset) is set up for each timing difference by multiplying the timing difference by the change in the tax rate. This results in a net regulatory liability of $1,400 as well as a reduction to ADFIT in the same amount.[14] The revalued ADFIT balance of $2,100 ($3,500 original - $1,400 for change in tax rate) represents the future tax liability that the utility will pay to the IRS. The $1,400 regulatory liability is the amount of deferred taxes that the company has collected in rates ($3,500) that exceeds its future tax liability ($2,100).

As you can see in this example, by including the excess ADFIT associated with the NOL carryforward, it ensures that the cash that is returned to customers is exactly the amount that customers provided to the utility.

Q. SO HOW WOULD STAFF'S RECOMMENDATION DIFFER FROM THIS EXAMPLE?

A. Staff's recommendation is to exclude the NOL carryforward ADFIT and the associated excess ADFIT. So let's modify the example to show these recommendations. Total tax expense remains $3,500 as Staff does not dispute this aspect of the calculation. The split of current and deferred tax expense remains the same, with $0 current and $3,500 deferred tax expense. Since Staff's recommendation excludes the NOL carryforward

[14] For simplicity purposes, this example does not include any gross-up of the regulatory liability.

ADFIT, we would have a rate base reduction of $3,850 as opposed to the $3,500 in the example above. The revaluation of ADFIT as a result of the tax rate change in Staff's recommendation would result in a regulatory liability of $1,540. The utility has collected $3,500 for deferred tax expense from customers. The Company will still be required to pay $2,100 in tax expense in future years. Yet, Staff recommends that $1,540 be "returned" to customers. This results in the utility now having only $1,960 ($3,500 – $1,540) of cash remaining from its customers to pay its future tax liability of $2,100. Below is the last set of data modified for Staff's recommendation.

	Taxable Income		Tax Rate	**(DTL) / DTA**		Reduction to Tax Rate	**Reg. (Liability)**
Pre-Tax Book Income	10,000						
Accelerated Tax Deduction Reducing Income to Zero	(10,000)	x	35%	(3,500)	x	14%	(1,400)
Remaining Accelerated Tax Depreciation	(1,000)	x	35%	(350)	x	14%	(140)
Taxable Income (Loss)	(1,000)			(3,850)			(1,540)
Net Tax Loss Carry Forward	1,000	x	35%	0	x	14%	0
Taxable Income After Net Operating Loss	0						
	35%						
Current Tax Expense	0			(3,850)			(1,540)

The Company's position that the NOL carryforward related excess ADFIT should be included in the overall excess ADFIT balance provided to customers ensures that the amount that is returned to customers is the exact amount that customers have paid in excess taxes to the Company.

Q. STAFF PROPOSES A REFUND OF $14,494,385 TO TEXAS CUSTOMERS RELATED TO THE AMORTIZATION OF PROTECTED EXCESS ADFIT THROUGH THE RELATE-BACK DATE OF MARCH 18, 2021. DO YOU AGREE WITH THIS AMOUNT?

A. No, I do not. A calculation of the refund to Texas Retail customers related to the amortization of protected excess ADFIT has been provided in Exhibit DAH-1R. As shown in the exhibit, the Company proposes a refund of $9,295,525 to Texas Retail customers. There are two errors or omissions that have been identified in Staff's calculation.

First, Staff's calculation of the protected excess ADFIT amortization excludes the impact of the excess ADFIT for the Company's NOL carryforward. The exclusion of the NOL carryforward excess ADFIT is not appropriate for the reasons provided earlier in my testimony.

Second, Staff's calculation uses a Texas Retail allocation factor of 36.94%. The calculation provided by the Company has a 35.01% Texas Retail allocation factor.[15] The factor used in the Company calculation is based on the allocation factors that were approved with the rates set in Docket No. 46449. This is the appropriate allocation factor to use as it represents the Texas Retail allocation that was in effect at the time of the tax rate change that resulted in the excess ADFIT balance. This allocation factor represents the proportion of the total company deferred taxes that were included in the rates of Texas customers, and therefore, it is the proportion of excess ADFIT that should be returned to Texas customers.

Q. STAFF REJECTS THE COMPANY'S PROPOSED PROFORMA ADJUSTMENT OF $4,664,032 TO THE PROTECTED EXCESS ADFIT AMORTIZATION IN THE COST OF SERVICE. DO YOU AGREE WITH STAFF'S POSITION ON THIS ADJUSTMENT?

[15] Exhibit DAH-2R

A. No, I do not. This proforma adjustment is to adjust the test year amortization of protected excess ADFIT to include the excess ADFIT on the Company's NOL carryforward. As explained earlier in my testimony, this adjustment is required to ensure that the Company returns the amount of cash that it collected from customers through rates for its deferred taxes.

Q. STAFF CALCULATED A BALANCE OF UNPROTECTED EXCESS ADFIT TO BE REFUNDED TO TEXAS CUSTOMERS OF $31,311,597. DO YOU AGREE WITH THIS AMOUNT?

A. No, I do not. A calculation of the refund due to Texas Retail customers for the balance of unprotected excess ADFIT has been provided in Exhibit DAH-3R. As shown in the exhibit, the Company proposes $29,678,864 of unprotected excess ADFIT that is to be refunded to Texas Retail customers. Again, Staff's calculation uses an allocation factor of 36.94% to determine the Texas jurisdictional amount. As explained in the Q&A immediately above, the allocation factor should be based on the rate used to allocate deferred taxes in Docket No. 46449 – 35.01%.

V. CONCLUSION

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.

A. The Company's request to include the Company's separate return NOL carryforward ADFIT is consistent with the requirements of Texas state law as set forth in PURA §36.060 as well as the normalization rules of the Internal Revenue Code. Inclusion of the NOL carryforward ADFIT ensures that the rate base reduction for ADFIT is consistent with the deferred tax expense that customers have paid through rates. The inclusion of the excess ADFIT related to the separate return NOL carryforward ensures that the refund that the Company returns to customers is equal to the amount that the Company has over-collected in rates for its deferred tax expense.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.

Refund for Protected Excess ADFIT Amortization

		COMPANY	STAFF
1	2018 Amort Per Books	10,080,455	10,080,455
2	2019 Amort Per Books	8,562,396	8,562,396
3	Amortization - NOL Excess	(4,626,403)	-
4	Jan through March 2020 Projected Amort	2,542,157	2,542,157
5	Jan through March 2020 Projected Amort - NOL Excess	(1,194,345)	-
6	Projected amortization through Test Year-End	15,364,260	21,185,008
7	Projected Amort. 4/1/2020 through 3/18/2021	9,848,719	9,812,724
8	Tax Return True-up of 2019 Amort Per Books	366,919	-
9	Projected Amort. NOL Excess	(4,606,830)	-
10	Projected amortization 1/2018 through 3/18/21	20,973,069	30,997,732
11	Percent allocated to Texas	35.01%	36.94%
12	Texas Jurisdictional	7,343,465	11,450,562
13	Gross-up Rate	1.265823	1.265823
14	Texas Refund - Protected Excess Amortization	9,295,525	14,494,385

Excess ADFIT Texas Jurisdictional Allocator

	Generation	Transmission	Distribution	Total	
Protected Excess ADFIT	(291,262,049)	(92,935,224)	(113,434,585)	(497,631,858)	
Unprotected Excess ADFIT	(22,769,577)	(12,164,752)	(32,028,739)	(66,963,068)	
Total Excess ADFIT - Total Company	**(314,031,626)**	**(105,099,976)**	**(145,463,324)**	**(564,594,926)**	
Allocation Factor per Docket No. 46449	33 62%	38 45%	35 54%		
Total Excess ADFIT - Texas	**(105,577,433)**	**(40,410,941)**	**(51,697,665)**	**(197,686,039)**	**35.01%**

Allocators per Docket No. 46449	Total Co ADIT	TX ADIT	Texas %
Generation	(692,813,389)	(232,891,926)	33 62%
Transmission	(224,765,159)	(86,426,400)	38 45%
Distribution	(328,254,136)	(116,652,925)	35 54%

Refund for Unprotected Excess ADFIT

		COMPANY	STAFF
1	Excess Balance 01.01.18	(50,479,142)	(50,479,142)
2	Amended Return Remeasurement	(252,148)	(252,148)
3	2017 RTP + Reclassifications	(16,231,778)	(16,231,778)
4	Unprotected Excess - Total Company	(66,963,068)	(66,963,068)
5	Allocation Factor per Docket No. 46449	35.01%	36.94%
6	Unprotected Excess - Texas	(23,446,303)	(24,736,157)
7	Gross-up Factor (1 / (1 - 21%)	1.265823	1.265823
8	Unprotected Excess - Texas Refund	(29,678,864)	(31,311,597)

S.B. No. 1364

AN ACT

relating to the computation of an electric utility's income taxes.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. Subsection (a), Section 36.060, Utilities Code, is amended to read as follows:

(a) If an expense is allowed to be included in utility rates or an investment is included in the utility rate base, the related income tax benefit must be included in the computation of income tax expense to reduce the rates. If an expense is not allowed to be included in utility rates or an investment is not included in the utility rate base, the related income tax benefit may not be included in the computation of income tax expense to reduce the rates. The income tax expense shall be computed using the statutory income tax rates. [~~Unless it is shown to the satisfaction of the regulatory authority that it was reasonable to choose not to consolidate returns, an electric utility's income taxes shall be computed as though a consolidated return had been filed and the utility had realized its fair share of the savings resulting from that return, if:~~

[~~(1) the utility is a member of an affiliated group eligible to file a consolidated income tax return; and~~

[~~(2) it is advantageous to the utility to do so.~~]

SECTION 2. This Act takes effect September 1, 2013.

S.B. No. 1364

President of the Senate | Speaker of the House

I hereby certify that S.B. No. 1364 passed the Senate on April 23, 2013, by the following vote: Yeas 24, Nays 7.

Secretary of the Senate

I hereby certify that S.B. No. 1364 passed the House on May 20, 2013, by the following vote: Yeas 137, Nays 8, one present not voting.

Chief Clerk of the House

Approved:

Date

Governor